ANCHOR CAPITAL
INVESTOR CAMPUS

GLOBAL IDEAS

11 April 2014

WWW.ANCHORCAPITAL.CO.ZA
WWW.INVESTORCAMPUS.COM

The Walt Disney Company: The Mouse That Roars

Investment summary:

- The Walt Disney Company (Disney) is a diversified international entertainment and media company operating in five business segments: media networks, parks and resorts, studio entertainment, consumer products and interactive media.
- Since November 2013 Disney's earnings and revenues have been rising on a quarterly basis, and in 1Q14 the company reported a YoY revenue increase of 9% to $12.3bn, with net income up an impressive 33% YoY to $1.84bn, or $1.03/share.
- Media networks accounted for 60%+ of Disney's operating income in FY13, recording a 5% YoY increase in FY13 revenue to $20.4bn. It is one of the company's most dependable revenue generators, with the cable sports channel ESPN being the proverbial 'golden goose' for Disney. According to *Market Realist*, it represents c. 50% of Disney's overall profit, giving the company a significant foothold in the extremely lucrative US sports market.
- We believe some of the key positives for Disney includes ESPN, its successful integration and monetisation of acquisitions, lucrative movie franchises, parks and resorts, its digital distribution agreements, attractive margins, free cash flow, returning cash to shareholders and its CEO Bob Iger who's term was recently extended until 2016.
- However, the company also faces some headwinds in the form of its video gaming segment which, despite performing well in the last quarter, has been a money pit for Disney for some time now and is expected to return to a loss in 2Q14. The already high and constantly increasing content costs and its ABC network could turn into a earnings drag for Disney, while external factors such as macroeconomic and adverse weather conditions could also negatively impact the company. Although its theme parks have been performing well this segment especially could be negatively impacted in the event of a major economic slowdown or continued inclement weather.
- We see ESPN (with its soaring ad revenue and affiliate costs), the Marvel and Star Wars franchises, the potential in China and other emerging economies, digital content distribution, its deal with Netflix and merchandising as some of the key drivers for the business.
- Disney's share price has performed exceptionally well over the past two years rocketing c. 78% since mid-March 2012. Despite this we think it's a company investors should hold with a long-term view and at present we see a number of macroeconomic circumstances especially in the US that bode well for Disney, including 5-year low unemployment levels, robust corporate earnings growth and strong consumer spending data. Disney's share price momentum will likely continue to build because of the company's healthy fundamentals and above-market growth potential. BUY.

Disney's forecasts are as follows:

Disney				
September y/e	**FY13**	**FY14E**	**FY15E**	**FY16E**
EPS ($)	3.4	4.1	4.6	5.2
% growth		*18%*	*13%*	*14%*
DPS ($)	0.8	0.9	0.9	1.0
P/E	22.7x	19.1x	16.9x	14.8x
DY	1.0%	1.1%	1.2%	1.3%
Share price ($)	**77.51**			
12-mnth fwd P/E	17.8x			

Source: Bloomberg, Anchor Capital

Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

Contacts

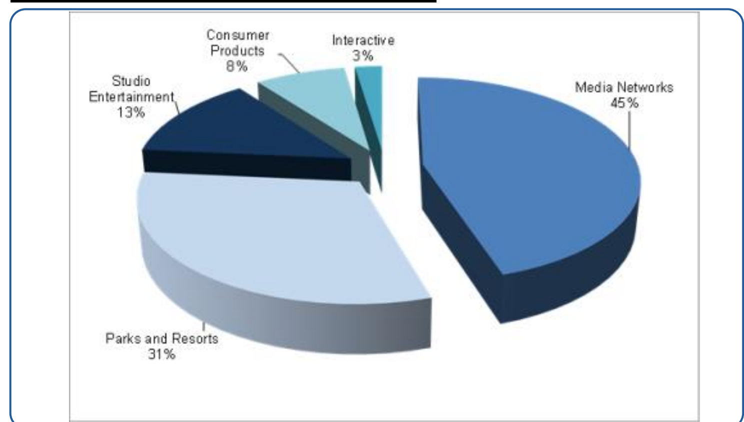
Anchor Capital reception	**011 591 0677**	**Trading Desk**	**012 665 3461**
Investment/ Sales	mnyoung@anchorcapital.co.za	General Enquiries	info@anchorcapital.co.za
Brokerage/ Trading	fswart@anchorcapital.co.za	Newsletter Enquiries	newsletters@anchorcapital.co.za

Disney's metrics are as follows:

Spot	77.51
MKT Cap (bn)	141.00
12M trailing P/E	22.10
12M fwd P/E	17.80
10-year average P/E	23.7
10-year average DY	0.54
FYE	28-Sep
P/Book Ratio	2.00
12M trailing DY	1.10
12M fwd DY	1.20

Source: Bloomberg, Anchor Capital

Disney FY13 revenue by division:



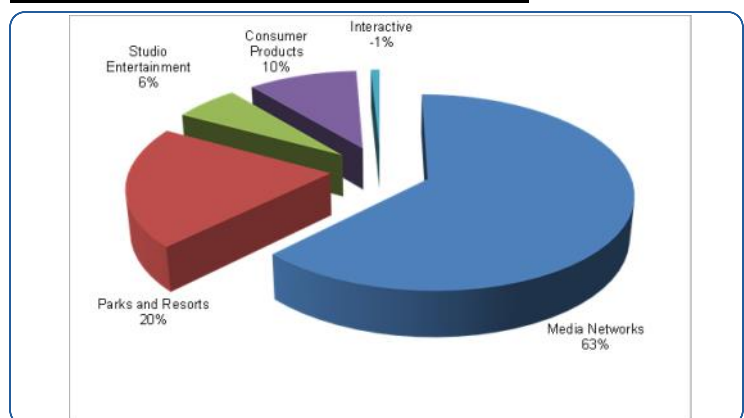
Source: Bloomberg, Anchor Capital

Company overview:

Walt Disney, founded in 1923, has been a household name for decades and the Walt Disney Company is one of the world's biggest and most well-known blue-chip diversified entertainment companies. Its assets span movies, television, publishing and theme parks. Its five divisions are:

- The **Media Networks** division **(c. 45% of FY13 revenue; 63% of FY13 operating profit)** includes US domestic broadcast television networks (ABC network, ESPN and Disney channel [both cable networks]), television production and distribution operations, broadcast radio networks (ESPN and Radio Disney) and stations, and publishing and digital operations.
- The **Parks and Resorts** segment **(c. 31% of FY13 revenue, 20% of FY13 operating profit)** includes Walt Disney World Resort (Florida), Disneyland Resort (California), Disney Vacation Club, Disney Cruise Line and Adventures by Disney. It also has ownership interests in Disneyland Paris, the Hong Kong Disneyland Resort and Shanghai Disney Resort, and licences the operations of the Tokyo Disney Resort in Japan.
- Its **Studio Entertainment** division **(c. 13% of FY13 revenue, 6% of FY13 operating profit)** produces and buys live-action and animated movies, direct-to-video programming, musical recordings, and live stage plays. It includes Walt Disney Pictures, Touchstone Pictures, Pixar, Marvel and Disney Nature. Under theatrical and home entertainment it has Walt Disney Records, Hollywood Records, Lyric Street Records, Buena Vista Concerts and Disney Music Publishing. It also owns Disney Theatrical Production which develops, produces and licences live entertainment events.
- The **Consumer Products** division **(c. 8% of FY13 revenue, 10% of FY13 operating profit)** engages with licensees, manufacturers, publishers and retailers globally to design, develop, publish, promote and sell a wide variety of products based on existing and new Disney characters and other intellectual property.
- The **Interactive Media** division **(c. 3% of FY13 revenue, operating loss of $87mn)** creates and delivers Disney-branded entertainment and lifestyle content across several interactive media platforms.

Disney FY13 operating profit by division:



Source: Bloomberg, Anchor Capital

1Q14 results:

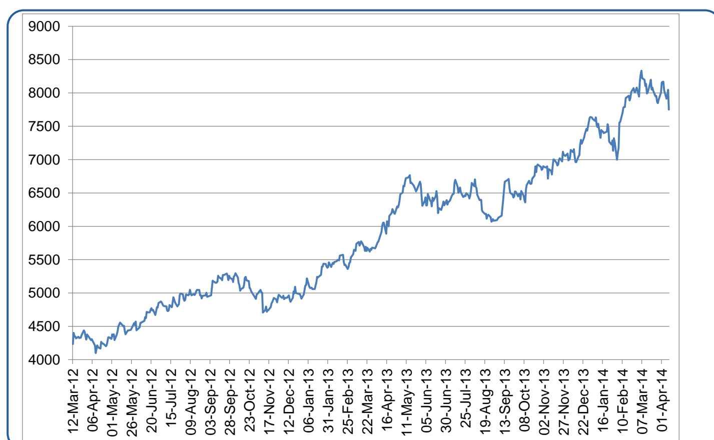
Since November 2013 Disney's earnings and revenues have been rising on a quarterly basis, and in 1Q14 the company reported a YoY revenue increase of 9% to $12.3bn, with net income up an impressive 33% YoY to $1.84bn, or $1.03/ share.

In terms of its divisions, the film studio produced a stellar performance, posting $409mn (+75% YoY) in operating income on $1.89bn revenue, with the latter up 23% YoY. This was due in large part to the strong box-office performance of Frozen (vs the lower base of Wreck-It Ralph in 1Q13) as well as the superhero sequel Thor: The Dark World. The performance was even more impressive taking into account that Disney took a write-down of c. $190mn on its flop 'The Lone Ranger' last summer. Disney CEO Bob Iger noted that the strong 1Q results were evidence that the studio's strategy of primarily investing in big-budget franchise films was succeeding. Disney Interactive was also a standout in 1Q14, with operating income up over sixfold to $55mn. This was the first time this division has had two consecutive profitable quarters, and revenue was up 38% to $403mn, driven by the video-game release 'Infinity' over the busy holiday-shopping season and strong sales of Disney-brand cellphones in Japan. However, here we note that with post-holiday sales tapering, CFO Jay Rasulo said that Disney Interactive would slip back into the red during the current quarter (2Q14) and the division was planning to dismiss several hundred of its employees as it tightens its focus on new versions of the Disney Infinity game and mobile content.

Disney's cable-networks unit continued to surge, with operating income up 34% YoY to $1.28bn on the back of growth at ESPN, A&E network (in which Disney is a minority owner), as well as domestic Disney channels. A 10% increase in ad sales at ESPN contributed to a 20% YoY increase in operating income at Disney's television unit. However, its broadcast division, which includes the ABC television network and some local stations, posted a 32% YoY decline in operating income (to $178mn), on the back of higher programming costs, lower ad revenue and lower sales from its television studio. Disney's theme parks in Florida, Tokyo and Hong Kong which has seen record attendance levels since last year delivered a 16% YoY increase for its Resorts division, while sales of Star Wars toys fuelled a 24% YoY rise at Disney Consumer Products.

Valuation:

Disney share price performance, USc:



Source: TimBukOne, Anchor Capital

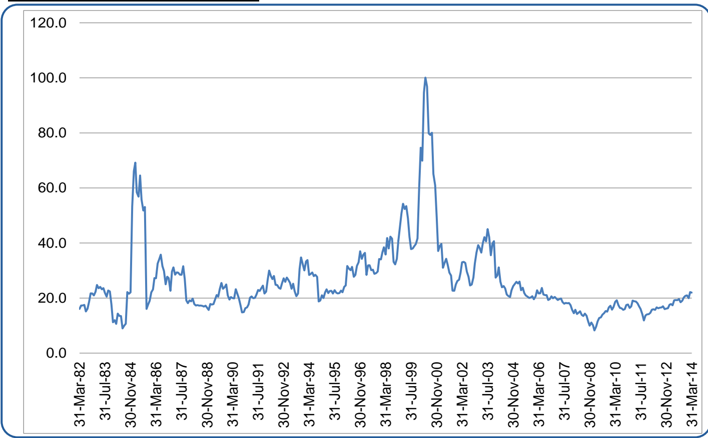
Walt Disney's share price has performed exceptionally well over the past two years rocketing by c. 78% since mid-March 2012 and gaining c. 34% YoY. The group is arguably the global leader in terms of diversified entertainment with its stakes in television networks, parks and resorts, movie studios, interactive media and consumer products. Disney has further strengthened its position through several acquisitions including Pixar (acquired in 2006), Marvel (in 2009 for $4bn) and Lucasfilm (in 2012 also for $4bn). With the acquisition of Lucasfilm comes one of the most lucrative franchises in cinema history - Star Wars. Added to that Disney also gets the rights to the Indiana Jones franchise (the Indiana Jones movies have grossed close to $3bn at the box office [US and international]). What also makes Lucasfilm such a great fit for Disney, a company that has been adept at using its movie and television properties to great effect over a wide variety of platforms including toys, books, games, theme parks etc. is that Star Wars practically invented movie-related merchandising and that franchise has, even more successfully than Disney, managed to integrate the Star Wars brand into several different but extremely lucrative moneymaking platforms. By adding the Star Wars franchise to its arsenal, Disney has sets itself up for decades of revenue generation with several standalone Star Wars movies already in early development and the first movie continuing on from the original saga scheduled to be released in December 2015. If there ever was a sure bet it is that the latest Star Wars instalment will make money – tons of it for Disney and so will the accompanying Lucasfilm properties like Indiana Jones.

So despite its share price having increased significantly over the past two years or so we believe it's a company investors should hold with a long-term view and at present we see a number of macroeconomic circumstances (especially in the US) that bode well for the company, including 5-year low US unemployment levels, robust corporate earnings growth and strong consumer spending data. Disney's long-term planning (in terms of theme park upgrades, new acquisitions etc.) is only starting to pay dividends now and as Disney rolls out its mega franchises (Marvel and Star Wars) in 2015, investors should see a significant increase in its studio profitability, which will likely buoy the company well into the future. Disney's enviable global leading position in the entertainment business and ESPN's dominant position in the world sport industry for several years hence (ESPN has deals locked with most major sporting events for at least the next 5-7 years) are factors that will spur growth, in our view.

Disney is also committed to returning cash to shareholders and it has $6.8bn in cash and generated $6.7bn in FCF in FY13. Looking at its earnings growth, Disney is expected to record double-digit earnings increases for at least the next three years based on *Bloomberg* consensus forecasts. This on the back of continued strong growth expected at the Media Networks and Studio divisions, further profit expansion at the Parks, and accelerated cash returns to shareholders (buybacks reached $1.7b in 1Q14). Share buybacks will likely account for around 5% of the company's earnings growth (*Bloomberg* consensus expects 18% growth in FY14 and 13% in FY15), thus 5% earnings growth is virtually guaranteed for the company.

We also find the valuation attractive at c. 17.8x 12M fwd P/E. The company has multiple segments and these are overwhelmingly reporting strong results (with the Interactive Media segment the exception). At the same time Disney also has a reputation for investing in its businesses and it has been making shrewd investment decisions over the past few years with Iger at the helm. Disney is also unique in the sense that it is a well-run business attached to a brand that is well-known (and loved in terms of its entertainment offerings) globally. Although the dividend yield is not huge (at c. 1.1%) it is at the same level as the average DY of its peer group (ex Disney) and since 2010 the company has been steadily increasing its dividend (it increased by c. 115% from FY10-FY13 and in FY13 Disney raised the common-stock dividend by 15% - the fourth straight yearly increase). Disney's dividends have also been increasing almost every year since initiation (with the exception of a dividend freeze in 2008 and 2009 during the global financial crisis) so it has a long history of paying dividends.

Disney historic P/E:

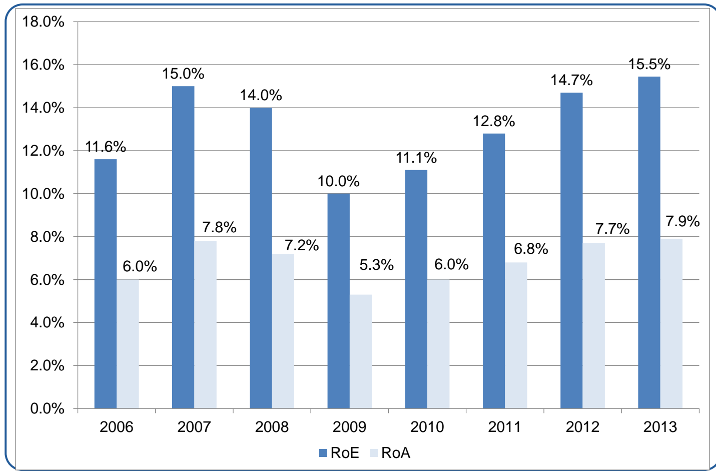


Source: Bloomberg, Anchor Capital

Some might argue that a company like Disney is dependent on discretionary income and it follows that in times of economic hardship the company will suffer. However, here we note that Disney does offer a hedging component as it has an international presence, an extremely powerful and well-known brand and, given the impressive value of its library and the dominance of its sports network (ESPN), it is more likely to continue beating market expectations and surviving an economic downturn. In terms of its 12M fwd P/E of 17.8x, we think this is attractive considering the company at one stage had a 100x plus P/E and its one-year historical average is around 20x. We are also of the view that with the investments the company has made in its various segments there is still significant growth left in the stock This is especially so in EMs such as China, Russia, Brazil, India and in terms of its acquisitions of Lucasfilm and Marvel with Disney not even beginning to harness the potential upside Lucasfilm properties have for the company.

Added to the above Disney has an impressive track record of profitability and there is no reason to believe this will change (in FY13 its revenue and profit reached new highs for a third-straight year). Disney's average return on equity (RoE) over a 5-year period is 13.1%, while its FY13 RoE stood at c. 15.5%, Since 2009 its RoE has been on an upward trend indicating the company is getting more adept at extracting value from the business.

Disney RoE and RoA, FY06-FY13



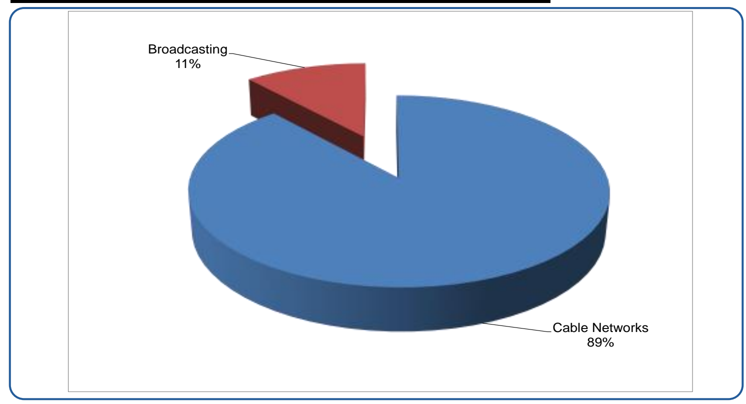
Source: Bloomberg, Market Realist, Anchor Capital

The following are what we believe to be the key growth drivers for Disney going forward:

1. ESPN:

Media networks accounted for 60%+ of Disney's operating income in FY13. The division recorded a 5% YoY increase in FY13 revenue to $20.4bn and is one of the company's most dependable revenue generators. Its cable sports channel ESPN (in which Disney has an 80% stake) makes up the lion's share (while overall total cable accounts for c. 89% of Disney's media networks segment's operating income). According to *Market Realist*, ESPN represents c. 50% of Disney's overall profit, giving Disney a significant foothold in the extremely lucrative US sports market.

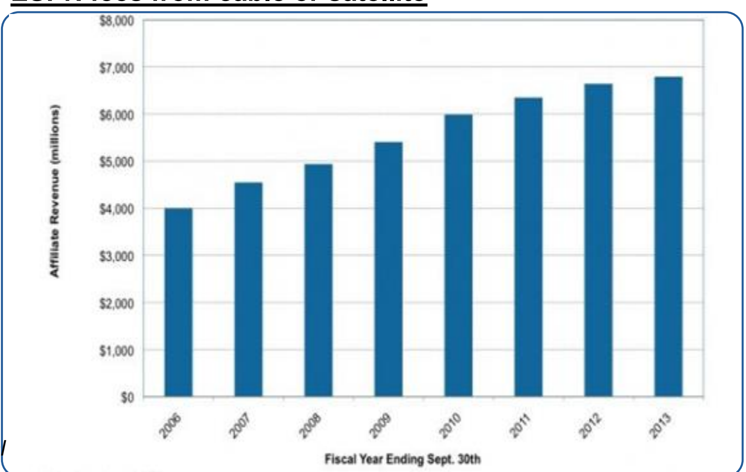
Operating income Media Network division:



Source: Company data, Anchor Capital

Although ESPN has been impacted by rising sports programming costs (mostly due to growing competition from 21st Century Fox, CBS and the NBC Sports channel), it has also benefited from contractual rate increases from cable providers and higher advertising sales. The channel remains the global leader in sports and even with growing competition it still commands the highest affiliate fees paid by cable systems (which are still on the rise). Since FY06, ESPN's affiliate fees have grown c. 70%. In the US broadcasting industry, a network affiliate is a broadcaster which carries some or all of the television or radio programmes of a network, however the affiliate is owned by a company other than the network owner. Affiliate fees are what broadcasters pay networks to allow them to air their programming. According to the *National Cable & Telecommunications Association* in FY13 ESPN received $5.15/subscriber per month and was seen in over 101mn homes.

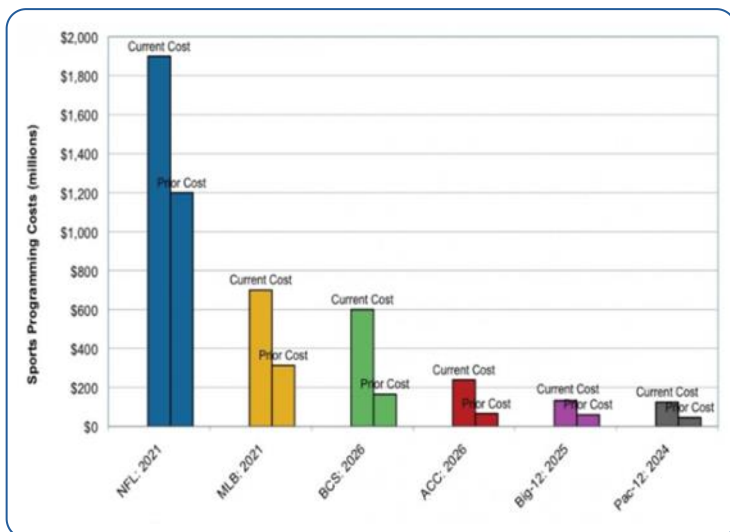
ESPN fees from cable or satellite



Source: Market Realist

With the popularity of sports programming at all-time highs, ESPN continues to lock-up content deals to maintain its leverage against other (and new) sports channels. Currently ESPN holds the rights to a number of professional and college sports programming, including the National Football League (NFL), the National Basketball Association (NBA), Major League Baseball (MLB), college football and basketball conferences, the National Association of Stock Car Auto Racing (NASCAR), Wimbledon, the US Open Tennis and the Masters Golf tournament. ESPN has also built itself Internet, global, mobile and radio businesses through which it has asserted its dominance in sports broadcasting and there is no doubt that it has a significant competitive advantage over other sports channels. So, although ESPN's success has been a catalyst for the launch of several competitors (as mentioned above) and this competition could lead to increased costs, the fracturing of its audience etc., as the chart below illustrates, ESPN has a defence against this - at least for the next six years plus. With the exception of NBA basketball (which has to be renegotiated and renewed by 2016) and NASCAR (by 2015), ESPN has nearly all its most -watched sports content locked until the 2020s – from 7-12 years hence. As an aside the chart (from *Market Realist*) also shows the significantly higher rates sports leagues were able to charge upon contract renewal – another indication of the current high value placed on sports programming.

ESPN sports programming rights:



Source: Market Realist

Importantly, ESPN attracts pay-tv providers (and therefore also higher ad rates), while at the same time it has a large and established subscriber base and, as mentioned previously, the network receives an estimated $5+/month for each subscriber that receives the channel. This is more than any other non-premium network and because ESPN is part of a basic cable bundle, subscribers can't reduce their bill by opting out of receiving the channel. More importantly for advertisers the major positive of sports broadcasting and reporting on the outcome of sporting events is that digital video recorder (DVR) viewing accounts for a far smaller chunk than is the case with traditional TV shows. Viewers overwhelmingly prefer watching their favourite sporting events live. This means these viewers are less likely to skip any ads that are played during a major sports broadcast—advertisers literally have a captive audience. The value of this for advertisers is immeasurable and ESPN has taken advantage by charging increasing rates for advertising on the network. Its ad revenue has effectively increased c. 90% over a period of seven years and there is no reason why ESPN will not continue to grow its ad revenue well into the future.

With its higher advertising rates driving revenue growth for Disney (for some time already) this should result in ESPN maintaining its position as one of Disney's key profit drivers for the foreseeable future. The popularity of sports programming, along with the ability to bundle channels, has enabled ESPN to demand higher fees from cable and satellite companies than any other network. The channel is also an industry leader when it comes to digital innovation and expansion, using technology to take sports fans closer to the action than ever before and to keep them connected with the world's best sports content 24/7. In addition to the technological advances being developed to enhance its sports coverage, ESPN also continues to pioneer new ways to engage sports fans. Its Watch ESPN service is now available to more than 55mn US homes, allowing fans to stream live sports programming on a variety of devices. The channel continues to lead the digital media sports space and in November alone, it reached over 68mn fans across digital platforms, with these sports fans spending more than 4bn minutes during that month alone connected to ESPN on their smart phones and tablets. ESPN's tagline is the "Worldwide Leader in Sports" and on every level it is truly in a league of its own.

2. Successful integration and monetisation of acquisitions:

Disney is extremely effective at integrating its acquisitions (Pixar, Marvel) and on the back of past experience there is no reason to believe Disney will not be able to leverage the Lucasfilm brand in the same way. The company also has a huge assortment of impressive businesses, all of which have synergies and, added to that, it has various JVs including online video service Hulu and Fusion (the first cable channel aimed specifically at English-speaking Latinos).

3. Lucrative movie franchises:

Overall, Disney movies have performed phenomenally at the box office (with the notable exception of last year's The Lone Ranger) and towards the end of 2013 Disney hit box-office gold with its animated phenomenon Frozen, which has grossed over $1bn globally to date. Disney also reported its best year ever in terms of global box office revenue in 2013 passing the $3bn mark, while in the US it made $1.72bn at the box office giving it a total of c. $4.73bn for the year (vs $3.6bn in 2012, up c. 32% YoY). This is even more impressive an achievement when we take into account that last year saw one of its biggest financial flops ever, the aforementioned The Lone Ranger on which it recorded a loss of up to $190mn. Although Warner Bros (WB) came in at number 1 in terms of 2013 global box-office takings (Disney was second), we note Disney released far fewer films—10 vs the 19 movies released by WB. Disney's biggest hit came from its Marvel properties in the form of Iron Man 3, which led 2013 with a $1.2bn box office take (the only 2013 release to hit $1bn), followed by Monsters University ($743.6mn) and Thor: The Dark World (another Marvel property which made $629.9mn).

It follows that any boom at its movie studio (or for that matter any huge hit movies it releases) increases its licensing fees for toys, and especially so for Disney's Marvel and Lucasfilm franchises which are effectively built for merchandise sales.

According to *24/7 Wall St.* which evaluated the value of the Star Wars brand in early 2012, total sales at that stage stood at over $30.5bn (this included box-office takings, video games, licensing, DVD sales and movie rentals AND this figure is unadjusted for inflation). To say Disney negotiated a bargain with the purchase of LucasFilm is an understatement. The company paid $4bn and will add untold billions of dollars to its coffers for years and years into the future. A sure revenue (and growth) driver for the company. So with Avengers 2 and Star Wars 7 in 2015, Disney will likely be releasing two $1bn movies in 2015 (although Star Wars is scheduled for release in December and thus its performance will flow through to 2016). Through these movies Disney is also building itself an annual franchise which will no doubt provide the company with stable cash flows well into the future. Analysts expect the Marvel universe to generate an average of $1.25-$1.5bn p.a. at the box office while each annual Star Wars movie (including character-driven spin-offs and others following the original movies' timeline) is expected to bring in at least $700-$900mn. Star Wars movies as a franchise have brought in c. $7bn globally since the release of the first movie in 1977 (unadjusted for inflation). At the same time, Pixar and Disney Animation have consistently brought in $800mn-$1bn at the box office. Expectations are high for these three franchises to generate significant earnings for the company at the box office. Added to that there is also home video sales, digital sales, licensing and an increase in attendance at its theme parks (expected with Disney also expanding into the Marvel and Star Wars universes at its parks). It was also recently announced that Pixar will be increasing its slate of movies p.a. from one to three movies every two years – another revenue driver for Disney. In the extremely profitable and very competitive animation market, Disney remains king while the lucrative Lucasfilm and Marvel franchises are sure to further buoy its box-office takings.

While most media companies are lucky if they have only one blockbuster franchise, Disney has an unparalleled stable of characters with Marvel, Star Wars, Pixar and Disney Animation. Disney is also able to uniquely monetises its franchises and characters across numerous platforms including movies, TV shows, theme parks, merchandise etc. At the same time the group's content production is stronger than it's ever been which will be a key growth driver for the business.

4. Parks and Resorts:

Disney's parks and resorts span across the globe, with locations in France, Hong Kong and Japan. The company has put a lot of investment in place over the past few years in its Parks division and a driver for the next three to five years will be harvesting the returns from those investments including increasing its market share and creating long-term business opportunities. This strategy of investing in Parks & Resorts seems to have already paid off to a degree with this segment recording a gain in revenue of c. 10% for FY13 (its theme parks in California, Florida, Tokyo and Hong Kong posted record attendance levels in FY13) and a 6% YoY increase in revenue for 1Q14. The company also recently announced it was going to unveil a Marvel-themed attraction at its Hong Kong Park and Disney will also be building a park in Shanghai (with a scheduled completion date of 2015). Added to that it has installed MyMagic+ at Walt Disney World, a technology system that starts with guest interface, planning, and ultimately improves the guest's experience along the way.

5. Digital video distribution:

In terms of digital video distribution and streaming of its movies and TV shows etc. Disney has recently done deals with a variety of market players. Below we highlight some of these deals:

5.1. Apple:

Disney recently announced an expanded partnership with Apple on a service called Disney Movies Anywhere which allows an Apple device user to purchase, store, and stream Disney, Pixar, and Marvel movies via iTunes. Currently, Disney Movies Anywhere, is supported only by iTunes. However iTunes is a retailer that accounts for c. 33% of all digital movie sales (*The NPD Group* data). According to *Digital Entertainment Group (DEG),* consumers spent nearly $1.2bn buying movies and TV shows digitally in 2013, up from $808mn in 2012. The key driver behind the jump is the growing tendency of studios to release big titles digitally two or three weeks ahead of their release on disc.

5.2. Maker Studios:

In late March this year Disney bought Maker Studios for $500mn, with an additional $450mn waiting for Maker's founders and backers if certain aggressive growth targets are met. Maker Studios is one of the largest online video networks and one of a number of so-called multichannel networks (MCNs) on YouTube, which means it operates as well as partners with several popular channels on the video site. In a statement Disney said the deal puts it at the centre of short-form online video, a niche Iger described as "growing at an astonishing pace." Maker's YouTube channels have more than 4.5bn monthly video views, and over 340mn subscribers. According to a recent *FT* article, media research firm *IHS* notes that while TV viewing is relatively flat, total video viewing is going up, driven by companies like YouTube. The article also highlights that advertisers will have spent a projected $5.6bn on YouTube last year (up 50% YoY) while another report from *eMarketer* predicts that YouTube's net revenue will be $1.96bn once advertising revenue partners have been paid giving it 1.7% of all global digital advertising spending. Through its acquisition of Maker Studios, Disney now has a foothold in an extremely lucrative and growing industry and access to the extremely lucrative millennials demographic.

5.3. Netflix:

Disney has also signed a multi-year original content deal with Netflix for several new live-action series based on its Marvel properties. This deal reinforces its partnership with Netflix – last year Disney signed a deal (valued at several hundred million dollars) with the company to sell its theatrical movies to the streaming service from 2016.

All of the above moves by Disney indicate a dedication to getting its product onto the new wave of digital media content delivery. The phenomenal growth of a streaming service like Netflix has shown that more and more people prefer to use online streaming – allowing them to watch what they want, when they want and at the same time costing less than a traditional US cable subscription. With the traditional TV watching model being turned on its head this is a way for Disney to stay ahead of the curb and allow consumers access to its shows and movies.

6. Consumer Products:

Disney is extremely adept at using its brands to sell products like books, magazines, comic books, toys etc. To help boost distribution of its products even further, the company operates 214 retail locations in North America, 88 in Europe and 46 in Japan. Merchandise tied to popular films and TV shows will continue to be a revenue driver for the company. Through its Disney Consumer Products division, Disney is able to take advantage of the very successful Marvel movies and Star Wars in merchandising agreements across multiple platforms. Its Disney Junior content and decades of successful animated hit movies as well as the recent megahit Frozen provide it with further merchandising clout. All of these well-known and loved properties will make sure the Disney merchandising behemoth continues driving profit for the company well into the future. Frozen merchandise is driving strong sales for Disney, and the company is also planning to take an adaption of the movie to Broadway (it has previously done this successfully with its Lion King and Beauty and the Beast properties).

7. CEO Bob Iger:

Robert Iger has, by all accounts, done a fantastic job with the company since he became CEO in 2005, making shrewd acquisitions and continuing to invest in Disney's parks, media assets and consumer goods business. He has been credited with revitalising the company after it lost some of its shine in the first half of the last decade. Iger was also instrumental in the acquisition of Pixar, Marvel Entertainment and Lucasfilm. Under his watch Disney has become a global diversified media juggernaut. Iger's tenure has now been extended to 2016 which is extremely positive for the company.

8. Free cash flow:

Disney has grown its free cash flow (FCF) by over 136% between FY11 and FY13 – a trend which continued in 1Q14. In FY13, Disney generated FCF of $6.7bn (+59.2% YoY) and the company ended the year with borrowings of $12.8bn and shareholders' equity of $45.4bn, excluding a non-controlling interest of $2.7bn. Disney's strong cash flow generation means it is in a good position to enhance shareholder value through its share repurchases.

9. Returning cash to shareholders

Disney has shown its commitment to returning cash to its shareholders through both dividends and share buybacks. In terms of share buybacks, Disney is a regular buyer of its stock and in 2013 the company announced it plans to buy back $6bn-$8bn of stock starting in 2014 (this represents c. 5% of the company's current market cap). Disney repurchased $4.1bn of its stock in 2013. While its dividends may not be huge (it has a 1.1 DY), Disney's dividends have been increasing almost every year since initiation (with the exception of a dividend freeze in 2008 and 2009 during the global financial crisis). In FY13 it raised the common-stock dividend by 15% - the fourth straight yearly increase.

10. Very attractive margins:

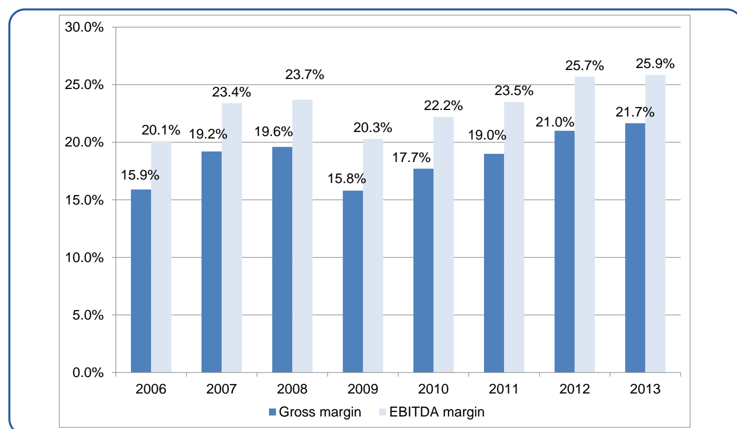
Although most of Disney's peer companies also look impressive on some statistical measures, Disney is more consistent across the board likely because it is a more diversified company than its competitors. Also 21st Century Fox, CBS Corp. and Time Warner don't have Walt Disney World Resort and Disneyland to fall back on if the media industry is impacted by a tough quarter or year. The fact that it has more diversified operating segments also means Disney can keep its margins more consistent and impressive. Disney's operating margin stands at c. 21.0%, while peer group companies including CBS, 21st Century Fox and Time Warner's operating margins come in at 21.5%, 19.4% and 23%, respectively. Disney has the lowest debt-to-equity ratio compared with the peer group at 0.35 (21st Century Fox's is 0.99, CBS' ratio is 0.62 and Time Warner is at 0.64) – confirming the relative strength of its balance sheet.

Peer group comparatives:

	Market Cap ($bn)	P/E Current	12M fwd P/E	DY 12M trailing	12M fwd	RoE, %	Operating margin	RoA, %	RoC, %	P/Book
21st Century Fox	75.0	24.9	20.2	0.8	0.8	21.6	19.4	8.5	14.0	4.3
Time Warner	58.9	17.2	16.9	1.8	1.9	12.3	23.0	5.4	9.0	2.0
CBS Corp	37.4	21.8	17.8	0.7	0.9	18.6	21.5	7.3	13.1	3.7
Average (ex. Disney)		*21.3*	*18.3*	*1.1*	*1.2*	*17.5*	*21.3*	*7.1*	*12.0*	*3.3*
Walt Disney Co	*141.0*	*16.7*	*17.8*	*1.1*	*1.2*	*15.5*	*21.0*	*8.5*	*11.9*	*2.0*

Source: Bloomberg, Anchor Capital

Disney margins:



Source: Bloomberg, Market Realist, Anchor Capital

11. China and other rapidly growing EMs:

After the US, China is the world's second-biggest (and fastest-growing) movie market. With the continuing success of Disney's movies in that country (Iron Man 3 was the second-highest grossing movie there last year and The Avengers the fourth-highest grossing in the country in 2012), there is tremendous potential not only for box office success but also for theme parks, consumer products etc. in China and Disney could be seen as a Chinese consumer play. More and more Hollywood studios are banking on China to turn a box office disappointment in the US into a successful property worthy of a sequel. A strong showing in China can now mean a sequel even if the movie was a financial flop in the US. In 2013 China's box-office takings surged 27% YoY to $3.6bn.

Excluding China other rapidly growing EMs (Russia, Latin America, Southeast Asia and India) also offer plenty of opportunities and Disney has been growing its presence in these markets. Besides China, Russia has also joined Japan and the UK as the biggest international markets for US movies thus opening up further opportunities for Disney in those markets. The company already has a free-to-air Disney Channel in Russia which it said earlier this year was now number one with kids in that country, while the huge success of Disney's locally produced telenovela for tweens in Latin America, has spread to Europe, Russia and beyond, spawning a thriving consumer products business as well as sold-out concerts around the world.

12. Robust financial results:

Disney's FY13 results were the third consecutive year of record results for the company reflecting the impact of its acquisitions, capital investments and its long-term strategy which (according to the company) focuses on "exceptional creativity, innovative use of technology and global growth".

Below we highlight the headwinds that Disney could face:

1. Disney's video game segment:

Although Disney's interactive division once delivered hits for the company, more recently it has become a money pit losing close to $1bn in recent years. However, Disney has been attempting to turnaround its struggling interactive division by reorganising it, reducing the number of video games it develops and altering its advertising strategy to focus more on the mobile market and losses from this segment seem to have narrowed down in FY13. However, whether it will be successful in completely turning the division around only time will tell but at present it is the one Disney segment that has been an albatross around the company's neck.

2. Already high (and ever-increasing) content costs:

The cost of sporting event rights and increased programming and production costs of television programmes and movies are near-term headwinds that could hurt the company's margins.

3. Theme parks:

To a degree the theme park business can be seen as a weight on the company and while it draws millions of customers the upkeep, labour, utilities, etc. does weigh on net margins. The fact that Disney recently decided to raise prices at its theme parks (which normally is done only in the US summer) has the potential to alienate families that simply cannot afford to visit. Many analysts also believe the parks were always a volume business and rather than a high ticket/high margin business. While the theme parks are probably the most cyclical of its business units, a stronger consumer should boost this division. The division will also be buoyed by Disney's theme park expansion into Asia.

4. Macroeconomic conditions:

Disney operates in the consumer discretionary space and an economic crisis or even an increase in prices and in the cost of living, in general, could result in a shift in consumer demand away from the entertainment and consumer products the company offers. Consequently this could adversely impact its revenues and increase its costs. Not only adverse economic conditions locally (the US) but also in Europe and in other regions where Disney operates can impact the company. However here we note that the six-year financial summary below shows that Disney has been growing revenues and operating income over the past four years with a slight dip appearing only during the GFC in 2009. FCF has improved significantly (nearly doubling) since FY08.

Disney financial summary (2008-2013), $mn:

	FY08	FY09	FY10	FY11	FY12	FY13
Revenue	37 843	36 149	38 063	40 893	42 278	45 041
YoY % change		*-4.5*	*5.3*	*7.4*	*3.4*	*6.5*
Operating income	**8 456**	**6 672**	**7 586**	**8 825**	**9 964**	**10 724**
YoY % change		*-21.1*	*13.7*	*16.3*	*12.9*	*7.6*
Capital Expenditure ($mn)	-1 586	-1 753	-2 110	-3 559	-3 784	-2 796
YoY % change		*10.5*	*20.4*	*68.7*	*6.3*	*-26.1*
Free Cash Flow ($mn)	**3 860**	**3 566**	**4 468**	**3 435**	**4 182**	**6 656**
YoY % change		*-7.6*	*25.3*	*-23.1*	*21.7*	*59.2*

Source: Company data, Anchor Capital

5. Adverse weather conditions and other disasters

Unfavourable weather conditions (including excessive rain, heatwaves, hurricanes, typhoons, tsunamis etc.) as well as other natural and man-made disasters can have a negative impact on Disney and especially its Parks and Resorts division. For example the Disneyland resort and Tokyo DisneySea in Japan closed down for around two weeks following the earthquake and tsunami that shook the country in 2011, resulting in a loss of revenue from those operations. Thus these type of events can impact Disney's ability to provide products and services to consumers.

6. Exchange rates:

Sharp exchange rate fluctuations (for example significant appreciation of the US dollar) could reduce international demand for its products or the US dollar value of revenue Disney receives from other markets. Conversely a significant decline in the dollar vs other currencies could increase its labour or supply costs in non-U.S. markets.

7. The ABC network:

The ABC network has been struggling in recent years (it recorded a 18% drop in profit last year) and with increased competition from digital downloads, streaming services, cable etc. it is likely that ABC will lag the rest of Disney's portfolio for the foreseeable future.

Conclusion:

After several years of investing in its theme parks businesses these investments are now starting to pay off with the company recording record attendance levels at its Parks and Resorts in FY13. Disney also has the most profitable movie franchises and studios (Marvel, Star Wars, Pixar) in its arsenal along with the worldwide leader in sports in the form of ESPN. The company has been making extremely savvy investments in the very lucrative streaming and online video market recently, signing deals with Netflix and Apple and acquiring Maker Studios. Disney also has a reputation for returning money to shareholders which is unlikely to change anytime soon. Added to this is the fact that its strong brands have a global appeal, and the Disney name is well known not only in the US but across the globe. With an emerging middle class in developing countries such as China, Russia, Brazil etc. the power of Disney's brands should help drive growth in its studio, television, merchandise and theme parks globally. Disney is currently trading at an attractive 12M fwd P/E of 17.8x and *Bloomberg* consensus expects the company to record double-digit earnings increases for at least the next three years. On top of that a number of macroeconomic circumstances (especially in the US) bode well for Disney, including 5-year low unemployment levels, robust corporate earnings growth and strong consumer spending data. We believe Disney's share price momentum will likely continue to build because of the company's healthy fundamentals and above-market growth potential. We would recommend investors BUY the stock.

Marco de Matos

The business of money: Global asset management and stockbroking

The business of knowledge: Financial education, information and valuation services

Disclaimer

This report and its contents are confidential, privileged and only for the information of the intended recipient. Anchor Capital (Pty) Ltd and Ripple Effect 4 (Pty) Ltd make no representations or warranties in respect of this report or its content and will not be liable for any loss or damage of any nature arising from this report, the content thereof, your reliance thereon its unauthorised use or any electronic viruses associated therewith. This report is proprietary to Anchor Capital (Pty) Ltd and Ripple Effect 4 (Pty) and you may not copy or distribute the report without the prior written consent of the authors.